

**Retiree Health Care Funding Vehicles in a GASB World**  
Sorting Out the Acronyms, Exploring the Options,  
and Finding a Solution

**W. Alan Wilk**  
California | Illinois | Michigan | Texas | Washington, D.C.  
[www.dykema.com](http://www.dykema.com)

---

---

---

---

---

---

---

**Introduction**

- ❖ W. Alan Wilk
  - Member of the Dykema law firm
  - Resident in Lansing Office
  - Special Assistant Attorney General
  - 12 years experience with SOM retirement plans
  - Specializes in public retirement federal tax compliance

---

---

---

---

---

---

---

**The “16 Acronym Dilemma”**

Should we use a 115, 401(h), VEBA, or HRA under the IRC to meet the ARC and GASB requirements and assist MPSERS, SERS, JRS, LRS, and SPRS meet the OPEB costs for future DB and DC retirees?

What will the IRS say?

---

---

---

---

---

---

---

## Retiree Health Care Funding Vehicles in a GASB World

- ❖ Sorting Out the Acronyms
  - Background
- ❖ Exploring the Options
  - Explanation of various alternatives
- ❖ Finding a Solution
  - Focus on two alternatives

---

---

---

---

---

---

---

## Sorting Out the Acronyms

### **GASB**

General Accounting Standards Board

Establishes and improves standards of financial accounting and reporting for U.S. state and local governments.

In 2004, they adopted standards that require public employers (Statement 45) and public plans (Statement 43) to disclose total liability of OPEB costs.

---

---

---

---

---

---

---

## Sorting Out the Acronyms

### **OPEB**

Other Public Employee Benefits

OPEBs are non-pension benefits offered by state and local governments to persons after they leave employment, such as retiree health care.

---

---

---

---

---

---

---

### Sorting Out the Acronyms

#### ARC

Annual cost of the past and future OPEB is called the Annual Required Contribution (ARC)

The ARC is determined by an actuarial valuation conforming to the GASB's parameters, with certain adjustments.

---

---

---

---

---

---

---

### Sorting Out the Acronyms

#### IRS / IRC

Internal Revenue Service – federal agency that oversees tax laws.

Internal Revenue Code – body of federal tax laws.

---

---

---

---

---

---

---

### Sorting Out the Acronyms

#### 29 USC 115 (Section 115)

Section 115 of the IRC –

Source of tax exempt status for governmental entities.

Commonly referred to as an “essential function trust”

A tool government entities can use to help pay for retiree health benefits.

---

---

---

---

---

---

---

### Sorting Out the Acronyms

#### **29 USC 401(h) (Section 401(h))**

Section 401(h) of the IRC –

A sub-account within a pension plan to which the plan sponsor may contribute funds dedicated to the purpose of funding retiree health benefits.

---

---

---

---

---

---

---

### Sorting Out the Acronyms

#### **VEBA**

Voluntary Employees Beneficiary Association –

A tax-exempt trust meeting requirements under section 501(c)(9) of the IRC.

---

---

---

---

---

---

---

### Sorting Out the Acronyms

#### **HRAs**

Health Reimbursement Accounts –

Individual health care savings accounts to which employers credit a defined amount earmarked for an employee's health expenses during retirement.

---

---

---

---

---

---

---

### Sorting Out the Acronyms

#### DB / DC

Defined Benefit – Plan guarantees a specific level of benefit with the employer providing the necessary funding.

Defined Contribution – Plan specifies the level of contributions paid into an individual account on behalf of each employee.

---

---

---

---

---

---

---

### Sorting Out the Acronyms

#### SERS/MPERS/JRS/LRS/SPRS

Retirement systems for the State of Michigan and certain political subdivisions

Pension plans are exempt under Section 401(a) and Retirement systems are exempt under 501(a) of the IRC

---

---

---

---

---

---

---

### Why are we Exploring the Options?

#### 1. Rising Cost of Retiree Health Care

Health care costs have outpaced overall inflation and growth in Michigan's economy.

---

---

---

---

---

---

---

**Why are we Exploring the Options?**

**2. GASB Accounting Standards for OPEB Liabilities**

If a governmental entity contributes less than what is required, the entity must report the shortfalls as liability on their financial statements. The liability may impact the government's bond rating factor.

---

---

---

---

---

---

---

**Why are we Exploring the Options?**

Current Status:

- ❖ DB or DC Employees for Retirement Plan
- ❖ Most everyone still has DB for Health
- ❖ Health Costs paid on a "Pay as you go" Basis (Annual costs of actual retirees are divided into total payroll to pay for those costs).

---

---

---

---

---

---

---

**Why are we Exploring the Options?**

Current Results:

- ❖ Each retirement system has enough for current retiree liabilities
- ❖ Little or no pre-funding takes place
- ❖ Pay as you go payment < ARC

---

---

---

---

---

---

---

**Why are we Exploring the Options?**

Health funds in the current retirement systems

- ❖ MPSERS – Section 115 account
- ❖ SERS – Section 115 account
- ❖ SPRS – Section 115 account
- ❖ JRS – Section 401(h) account
- ❖ LRS – Section 401(h) account

---

---

---

---

---

---

---

**Exploring the Options**

Options for where they should be in the future?

- ❖ VEBA
- ❖ Section 401(h) Account
- ❖ Section 115 Trust
- ❖ HRA

---

---

---

---

---

---

---

**Exploring the Options**

VEBA –

Are available to the private sector.

Highly complex from an administrative standpoint

No option for pre-tax employee money.

Examples – General Motors and the Ohio Retirement System.

---

---

---

---

---

---

---

**Exploring the Options**

- VEBA – Reasons for choosing another option –
- Administrative complexity
- Restriction on pre-tax employee contributions
- Requires prior IRS approval

---

---

---

---

---

---

---

**Exploring the Options**

- 401 (h) –
- A segregated fund within a DB plan.
- Allows for employer and employee contributions.
- Examples – JRS and LRS.

---

---

---

---

---

---

---

**Exploring the Options**

- 401(h) – Reasons for choosing another option –
- Subject to an IRC funding ratio.
- Health care contributions are limited to 25% of the pension contributions.
- IRS issues regarding employee pre-tax contributions.
- Unworkable for some SOM plans.

---

---

---

---

---

---

---



### Exploring the Options

- ❖ **Health Reimbursement Accounts**
- ❖ For employers, HRAs limit the extent of the employer's financial exposure to a defined dollar amount, and allow employers to restrict the uses of the funds to medical expenses only.
- ❖ Examples – Minnesota and MERS.

---

---

---

---

---

---

---

### Exploring the Options

- ❖ **Section 115** – A government trust formed under section 115 of the IRC for exemption from federal income taxes on its earnings is an attractive funding option for government employers.
- ❖ Examples – MERS, Alabama, Minnesota, California, and Los Angeles.

---

---

---

---

---

---

---

### Finding the Solution: Section 115 Trust Requirements

- ❖ An entity must meet certain requirements in order to qualify for tax-exempt status under Section 115.
- ❖ There is no formal guidance which indicates that a Section 115 trust qualifies for GASB purposes, although there are numerous third-party opinions that have reached that conclusion.

---

---

---

---

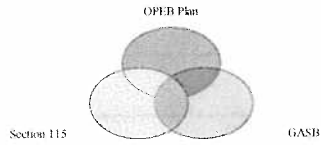
---

---

---

## Finding the Solution

### Overlap of 115, OPEB & GASB:



---

---

---

---

---

---

---

### Finding the Solution: Mandatory Section 115 Requirements

- ❖ Restricted Purpose – must perform an “essential function” of state government.
- ❖ Anti-alienation Provisions – no funds subject to transfer, assignment, or alienation.
- ❖ Exclusive Benefit Provisions – protect funds from being diverted.
- ❖ Provision on Remaining Assets – must be returned to the employer.
- ❖ Comprised Solely of Governmental Contributions - possible restriction on employee funds

---

---

---

---

---

---

---

### Finding the Solution:

#### Steps for a 115 Trust:

- ❖ Statutory provisions
- ❖ Trust Agreement
- ❖ Health Plan
- ❖ Implementation by State and Retirement Systems

---

---

---

---

---

---

---

### **Finding a Solution:**

#### **Funding for a 115 Trust:**

- ❖ Mandatory Employer Contributions
- ❖ Mandatory Employee Contributions
- ❖ Voluntary Employer Contributions
- ❖ (Voluntary Employee Contributions)
- ❖ Transfers of Existing Health Benefit Reserves

---

---

---

---

---

---

---

### **Finding a Solution**

#### **Flexibility of the 115 Trust:**

- ❖ Funding of Current Benefits
- ❖ Use of Excess Funds for ARC calculations
- ❖ Pre-funding of Future Benefits

---

---

---

---

---

---

---

### **Finding the Solution: Health Reimbursement Accounts**

- ❖ HRAs are health care savings accounts that employers pay in, and allow retirees to draw upon these amounts to pay for premiums for a retiree health plan and/or for reimbursement of retiree out-of-pocket medical expenses.
- ❖ Employers credit a defined amount earmarked for an employee's health expenses during retirement.
- ❖ Mandatory employee contributions (employer pick-ups) – HRAs might include mandatory salary reductions.

---

---

---

---

---

---

---

**Finding the Solution:  
“What will the IRS say?”**

- ❖ For government entities in limited cases, the IRS may issue “government affirmation letters” through a simplified process.
- ❖ In most other cases, in order for a government entity to receive a determination of its status as a political subdivision, instrumentality of government, or whether its revenue is exempt under Section 115 of the IRC, it must first obtain a letter ruling by following the procedures specified in Revenue Procedure 2007-4.

---

---

---

---

---

---

---